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C O N F I D E N T I A L SECTION 01 OF 02 ANKARA 000473

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EEB FOR A/S SULLIVAN

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TAGS: ECON EFIN TU
SUBJECT: TURKEY: FINANCING GAP LOOMS

REF: A. ANKARA 198
¶B. ANKARA 336

Classified By: Economic Counselor Dale Eppler for reasons 1.4 b, d

¶1. (C) Summary: There is a growing likelihood that Turkey will face a financing gap this year, which would pressure the exchange rate and make private sector borrowing much more difficult. Most of Turkey's financial indicators are deteriorating, and recent GOT announcements that indicate substantially increased government spending this year will not help. Private analysts project a financing gap in FY 2008 ranging from USD 8 to 20 billion. Key determinants of the size of the gap will be the GOT's fiscal discipline, Turkey's energy bill, the extent of private sector financing and repayments, and total inflows from privatizations, FDI and portfolio investments. In addition, IMF borrowings are likely to be cut in half this year due to delays in passing the Social Security Reform, increasing Turkey's financing needs by about USD 1.8 billion. Of these factors, the GOT can only control its spending, making recently announced spending initiatives even more worrisome. End summary.

¶2. (C) Turkey's financial indicators are deteriorating across the board. The Trade and Current Account Deficits are increasing, driven by Turkey's energy imports and the high lira. Economic growth is slowing, to an estimated 4% this year, with private sector growth expectations decreasing. Inflation remains far above the Central Bank's (CBRT's) 4% target, and private sector inflation expectations are rising. The 2008 budget projects a USD14.4 billion deficit, up nearly 30% from the already high 2007 deficit. Privatization proceeds and foreign direct investment (FDI) flows are projected to be flat, with some investment banks projecting lower privatization proceeds and FDI this year than last (Note: last year's USD 19 billion in FDI was very high, so reaching that level again this year will be an achievement. End note). Corporate debt is rising rapidly, much of it offshore borrowing in foreign currency. Private sector investment in plant and equipment stopped growing last year. Unemployment remains high at 9.9%, but the steady headline number hides the fact that the labor participation rate is falling while the working age population is increasing. None of these factors alone is critical. All of them taken together, in this global investment climate, are worrisome.

¶3. (SBU) Investment banking analysts have begun predicting that Turkey will have a financing gap this year, but are not in agreement on how large the gap will be, with predictions ranging from USD 8 to 20 billion. Four key variables will determine the size of this gap: whether the GOT maintains fiscal discipline; the size of Turkey's energy bill; private

sector borrowing and repayment; and inflows from privatizations, FDI and portfolio investments.

¶4. (C) Despite calls for fiscal restraint from the CBRT, World Bank, IMF and most recently from the private sector (reftel B), the GOT has announced three new spending initiatives that call even the relaxed 2008 budget deficit and lower, 5.5%-of-GDP primary fiscal surplus target into question. The Ministry of Transportation announced plans to establish an off-budget fund funded from both budget and privatization proceeds. The Southeast Development Package is expected to be rolled out soon and include expanded spending on infrastructure, housing, universities and energy systems. Prime Minister Erdogan also announced new legislation that would give local governments a share of indirect tax revenues, worth USD 3.22 billion this year, which would further dilute federal revenues.

¶5. (SBU) The size of Turkey's energy bill is one of the major factors determining the size of the Current Account Deficit. The 2008 budget optimistically assumed an average FY 2008 oil cost of USD 72 per barrel. In 2007, energy imports were USD 34 billion, accounting for 89% of the 2007 Current Account Deficit. This year, analysts predict an energy bill of around USD 41 billion, which would be 75-107% of analysts' projected Current Account Deficit for 2008. But with oil prices continuing to break records, the energy bill -- and Turkey's financing needs -- likely will exceed these estimates. According to investment bank estimates, a USD 1 rise in oil prices increases Turkey's Current Account deficit by USD 400 million.

¶6. (C) Private sector borrowing and debt repayment: Turkish

companies, particularly banks, have borrowed extensively offshore in the past few years, taking advantage of the strong lira and much lower interest rates abroad, but assuming a lot of currency risk. There are no official figures on the extent of this borrowing. The World Bank estimates the stock at USD 51 billion, a figure also used by the Ministry of Treasury. No one knows the extent to which this currency exposure is hedged. With credit markets tightening worldwide, many companies are starting to worry about their ability to refinance their foreign currency debt. Turkish Treasury officials told us this week that the GOT is not worried about its ability to meet its own borrowing needs. In response to business complaints, it plans to roll over only 40% of its foreign currency-denominated debt "and we could do much less if conditions warrant." That means that GOT borrowing in lira will be large, and Treasury officials conceded that the effect of this strategy would be to make it more expensive for small and medium sized companies to obtain domestic financing.

¶7. (SBU) FDI, privatization receipts and portfolio inflows: The 2008 budget projects privatization revenues of USD 9.0 billion, up slightly from USD 8.9 billion in 2007. It projects USD 18.5 billion in FDI, and USD 6.9 in portfolio inflows, a total of USD 34.4 billion. All three of these are heavily dependent on foreign investors' appetite for Turkish assets and instruments as they re-price risk globally. There is no consensus among analysts on these numbers, reflecting the uncertainty in financial markets, but the risks are almost all on the downside. One bank estimates higher portfolio inflows (USD 10.5 billion); all other 2008 private sector estimates for these three categories are lower. In addition to external factors, there are doubts about the political willingness of the GOT to proceed with unpopular energy sector privatizations, which were postponed before the 2007 elections and remain in the discussion phase.

¶8. (SBU) Borrowing from the IMF in 2008 also is in doubt. The GOT budget projected USD 3.6 billion in new IMF borrowing this year, against USD 2.4 billion in payments, for USD 1.2 billion in net funding. However, Turkey has not received

any funds from the IMF this year because the Seventh Review remains open, awaiting passage ofthe Social Security Reform. Technically, there are supposed to be two more reviews, but it seems unlikely that there will be time for them before the program ends in May. Assuming the Seventh Review is finally closed, and no additional reviews, Turkey is likely to receive only USD 1.8 billion in new IMF funds in 2008. This would mean a net outflow to the IMF for FY 2008 of USD 600 million (USD 2.4 billion in payments, less USD 1.8 billion in borrowing), and a net increase in Turkey's financing needs of USD 1.8 billion (USD 600 million in net outflow, plus the USD 1.2 billion in expected net inflows which will have to be covered by other borrowing).

¶9. (C) Comment: Of the four key variables, the GOT can only control the fiscal component. CBRT Governor Yilmaz, the IMF and World Bank all have been signaling for months that fiscal discipline will be crucial this year. This makes the recent announcement of new spending initiatives all the more worrisome. With Turkey's EU accession anchor tarnished, and the IMF anchor in doubt, this seems an odd time to loosen the fiscal anchor as well. If a financing gap emerges, it will likely have an immediate affect on the lira, pushing its value down. This would lead to higher inflation, as imported goods are a large component in the Turkish CPI basket. The increased GOT borrowing needed to cover a gap also would crowd out private sector borrowing in lira, pushing up borrowing costs for many companies unable to borrow abroad. End comment.

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